Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [redacted]:TL-N-4713-99
[redacted]

date: September 24, 1999

to: District Director, [redacted]
Attention: [redacted]
Manager, Examination Group [redacted]
[redacted]

from: District Counsel, [redacted]

subject: Assertion of Penalties for Understatements of Tax under I.R.C. §6662 Attributable to Negligence and Disregard of Rules and Regulations
Taxpayer: [redacted]
E.I.N.: [redacted]
[redacted]
Taxable Years Ended December 31, [redacted] and December 31, [redacted]

DISCLOSURE STATEMENT

This document may contain taxpayer information subject to I.R.C. §6103. This document may also contain confidential information subject to the attorney-client and deliberative process privileges, and may have been prepared in anticipation of litigation. Therefore, this document shall not be disclosed beyond the office or individual(s) to whom it is addressed and in no event shall it be disclosed to the taxpayer and its representatives.

Specifically, if this memorandum is addressed to a District Director's office or to another Counsel office, then only the office working the specific case or subject matter may use this document. This memorandum shall not be disclosed or circulated beyond such office personnel having the requisite "need to know".

This is in response to the memorandum dated July 19, 1999 from Senior Team Coordinator [redacted] requesting our assistance in determining the applicability of the penalty under I.R.C. §6662 to disallowed deductions for depreciation related to property financed by tax-exempt bonds and claimed by [redacted] ([redacted]) on its federal income tax returns (Forms 1120) for the taxable

years ended December 31, [redacted] and December 31, [redacted].

Based on the following discussion, the current evidence supports penalties for negligence and intentional disregard of rules and regulations under I.R.C. §6662 based on the understatements of tax attributable to the disallowed depreciation deductions claimed on [redacted] Forms 1120 for the taxable years ended December 31, [redacted] and December 31, [redacted]. The file does not contain evidence of reasonable cause and good faith under I.R.C. §6664 that might preclude assertion of penalties under I.R.C. §6662 and reflects that [redacted] did not make any adequate disclosure to avoid the penalty for disregard of rules and regulations under applicable Treasury Regulations and Revenue Procedures.

However, because [redacted] has not yet been given the opportunity to present evidence of reasonable cause and good faith under I.R.C. §6664 that might preclude assertion of penalties under I.R.C. §6662, we recommend that the Examination Division give [redacted] such opportunity. If [redacted] is unable to produce credible evidence that it exercised due care, penalties under I.R.C. §6662(a) and §6662(b)(1) should be asserted against [redacted] with respect to the understatements of tax attributable to the improper depreciation deductions in any Form 5701 (Notice of Proposed Adjustment), revenue agent report (RAR), Form 886-A (Explanation of Items), or notice of deficiency issued to [redacted] for the years ended December 31, [redacted] and December 31, [redacted]. In light of the agreement executed pursuant to I.R.C. §142(b)(1)(B)(i), it appears unlikely that [redacted] will be able to overcome its burden of establishing that it exercised due care under I.R.C. §6664 for purposes of avoiding penalties under I.R.C. §6662.

On the other hand, if [redacted] produces any evidence that tends to demonstrate reasonable cause and good faith, we recommend that you carefully consider whether the evidence is sufficient to satisfy [redacted] burden of refuting that the understatements are not attributable to negligence and disregard of rules and regulations under I.R.C. §6662(b)(1). If you need assistance in making such determination, we will provide additional assistance upon request.

Issues

1. Whether [redacted]'s understatements of tax for the taxable years ended December 31, [redacted] and December 31, [redacted] that are related to improper deductions for depreciation in the respective amounts of $[redacted] and $[redacted] are attributable to (a) negligence and/or (b) disregard of rules and regulations under I.R.C. §6662(b)(1).
U.I.L. 6662.01-00; 6662.01-01; 6662.01-02

2. Whether [redacted] made any adequate disclosure that precludes assertion of penalties attributable to disregard of rules and regulations under I.R.C. §6662(b)(1). U.I.L. 6662.01-02; 6662.02-02

3. Whether there is evidence of reasonable cause and good faith under I.R.C. §6664(c) that precludes assertion of the penalties attributable to (a) negligence and (b) disregard of rules and regulations under I.R.C. §6662(b)(1). U.I.L. 6664.03-00

Facts

At all relevant times, [redacted] has been [redacted] with a principal business consisting of [redacted]. [redacted] operates its business through wholly owned subsidiaries in the United States, Canada, and West Germany. In such business, [redacted] by ground and air transportation.

On [redacted], [redacted] entered into an agreement with the [redacted] ([redacted]) to finance the costs of acquisition, construction, improvement and equipping of an [redacted] to be used by [redacted] at the [redacted] ([redacted]). Under such agreement, the Airport Authority issued tax-exempt industrial development bonds (IDBs) totaling $[redacted] to pay for such costs.

The agreement provided that the [redacted] would be the owner of the [redacted] at [redacted] and lease the [redacted] to [redacted].

[redacted] Covenants Not to Claim Depreciation

Section [redacted] of the agreement with the [redacted] provided the following covenant by [redacted] with respect to the IDBs:

> ... to ensure that at all times during the term of the Bonds the property provided with the proceeds thereof be treated as governmentally owned within section 142(b) of the Code, and in pursuance whereof, the Company ([redacted]) further elects and covenants that:
>
> (i) it will not claim depreciation or an investment tax credit with respect to any property financed by the net proceeds of the Bonds and leased to the Company by the Board pursuant to the Agreements; and

(ii) it will not sublease, or transfer or otherwise assign its leasehold in, any property described in the preceding clause (i) unless as a condition to the effectiveness of the subletting, transferring or assignment in question the sublessee or assignee shall agree, in writing, with the Company (which agreement shall be binding upon the sublessee or assignee and shall be for the joint benefit of the Company and the [redacted]) that the sublessee or assignee, as applicable, shall not claim depreciation or an investment tax credit with respect to such property for purposes of federal income taxation; ...

Costs of Construction

Construction of the building to house the [redacted] at [redacted] was completed during [redacted]. The cost of such building totaled $[redacted].

Construction of leasehold improvements at the hub building was completed by December 31, [redacted]. The cost of such leasehold improvements totaled $[redacted].

[redacted] Tax Expertise

[redacted] is a sophisticated taxpayer with a large staff of employees devoted exclusively to compliance with federal and other tax laws. In addition, [redacted] makes extensive use of outside accounting services.

[redacted] Claimed Depreciation Deductions

[redacted] employees prepare [redacted] federal income tax returns (Forms 1120). On such Forms 1120 for the years ended December 31, [redacted] and December 31, [redacted], [redacted] claimed the following amounts of depreciation related to the building and leasehold property financed by the IDBs:

Taxable Year Ended	Amount Claimed
[redacted]	$ [redacted]

The claimed depreciation for the year ended December 31, [redacted] related only to the building. The claimed depreciation for the year ended December 31, [redacted] related to both the building and leasehold improvements. Depreciation was claimed under the regular modified accelerated recovery cost recovery system (MACRS) under I.R.C. §168.

Applicable Legal Authority Prohibiting Depreciation Deductions

One of the conditions for a leased airport facility to be eligible for financing by tax-exempt bonds is the lessee's irrevocable election not to claim depreciation or investment tax credit with respect to such property. See I.R.C. §142(a)(1), §142(b)(1)(A), and §142(b)(1)(B)(i); H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-709 (1986), reprinted in 1986 U.S.C.C.A.N. 4075, 4797 (1986). Consequently, in addition to the specific requirements for allowable depreciation under I.R.C. §167 and §168, [redacted] claim of depreciation related to the leased property at [redacted] financed with tax-exempt bonds is prohibited by [redacted] irrevocable election to waive any deductions for depreciation related to the leased property.

Disclosure by [redacted]

[redacted] is subject to the Internal Revenue Service's [redacted].

[redacted] did not attach a Form 8275 (Disclosure Statement) to its Forms 1120 for the taxable years ended December 31, [redacted] and December 31, [redacted]. However, in [redacted] "Statement Furnished under Rev. Proc. 94-69" dated [redacted] related to the taxable years ended December 31, [redacted], December 31, [redacted], December 31, [redacted], and December 31, [redacted], [redacted] made the following disclosure:

> In [redacted], [redacted] financed the construction of a facility at the [redacted] with proceeds from tax exempt bonds. These assets should have been depreciated using the alternative MACRS system. [redacted] depreciated these assets using regular MACRS. [redacted] will recalculate the depreciation and provide a schedule to the I.R.S. The assets were capitalized in [redacted] and [redacted].

[redacted] ([redacted]), [redacted] Federal Tax Manager as of [redacted], signed the Statement that contained the "under penalties of perjury" clause required by Revenue Procedure 94-69. [redacted] was a person authorized to sign [redacted] Forms 1120. Such declaration also states that [redacted] had examined the statement and "to the best of [her] knowledge and belief" that the statement was "true, correct, and complete".

However, [redacted] disclosure failed to reflect that any depreciation claimed with respect to the leased property for either of the taxable years ended December 31, [redacted] and December 31, [redacted] violated the provisions of the agreement and I.R.C. §142.

Agreed Disallowance of Deductions

Based on [redacted] irrevocable election not to claim depreciation deductions related to the leased facility at [redacted], the Examination Division has issued a Form 5701 and related Form 886-A disallowing [redacted] depreciation deductions related to the leased facility at [redacted] for the taxable years ended December 31, [redacted] and December 31, [redacted] on the ground that the deductions were not allowable under I.R.C. §142(b)(1)(B)(i).

[redacted] agrees that it was not entitled to claim the depreciation. In addition, [redacted] concession is not conditioned on the Service's agreement not to raise any penalty under I.R.C. §6662.

Miscellaneous Facts and Assumptions

The due dates (without regard to any extensions of time to file) for filing [redacted] returns for the taxable years ended December 31, [redacted] and December 31, [redacted] were the respective dates of March 15, [redacted] and March 15, [redacted]. Consequently, the amendments to the provisions of I.R.C. §6662 enacted by the Omnibus Budget Reconciliation Act of 1993 (OBRA) eliminating the disclosure exception for the negligence penalty and raising the disclosure standard for purposes of disregarding rules and regulations under I.R.C. §6662(b)(1) apply to [redacted] returns that are due after December 31, [redacted]. See OBRA, Pub. L. No 103-66, §13251, 107 Stat. 312, 531 (1993); H. R. Conf. Rep. No. 103-213, 103d Cong., 1st Sess. 1088, 1358 (1993), reprinted in 1993 U.S.C.C.A.N. 1088, 1358.

The file does not reflect any information concerning [redacted] internal controls related to ensuring that information necessary to prepare a correct tax return is provided to the employees responsible for preparation of [redacted] Forms 1120. Specifically, the file reflects no information on [redacted] efforts to reflect the substance of the agreement with the [redacted] in its books and records on which depreciation was claimed.

Violation of [redacted] agreement and the provisions of I.R.C. §142 jeopardizes the tax-exempt status of the bonds issued to finance the facility.

The Service does not intend to assert that any portion of the understatements related to the improper deductions for depreciation is a substantial understatement under I.R.C. §6662(b)(2) or attributable to fraud under I.R.C. §6663. For purposes of I.R.C. §6662(b)(1), the amount of tax attributable to any improperly claimed deductions for depreciation attributable to the facility at [redacted] will not be great enough to assert that any penalty applies based on a substantial

understatement of tax under I.R.C. §6662(b)(2). See I.R.C. §6662(d)(1)(A) and §6662(d)(1)(B).

[redacted] has not yet been given an opportunity to present evidence as to the reasons that it claimed the depreciation in violation of the provisions of its agreement and I.R.C. §142(b)(1)(B)(i). In addition, the file does not reflect that [redacted] or any of its officers, employees, or representatives conducted any analysis of or sought any legal or accounting advice from independent third parties about the validity of the depreciation deductions. Consequently, this memorandum does not focus on an assertion of reasonable cause based on a taxpayer's reliance on professional advice.

This case does not involve any claim related to the invalidity of a Treasury Regulation requiring the filing of a Form 8275-R (Regulation Disclosure Statement).

Because [redacted] concession related to the disputed depreciation deductions is not based on the Service's agreement not to assert any penalty under I.R.C. §6662, [redacted] should not argue that its concession precludes assertion of the penalties under I.R.C. §6662(a) and §6662(b)(1). See RAS of Sand River, Inc. v. Commissioner, T.C. Memo 1990-322, aff'd without published opinion, 935 F.2d 270 (6th Cir. 1991).

Issue 1 - Legal Discussion

I.R.C. §6662 imposes a penalty equal to 20% of any nonfraudulent underpayment of income tax attributable to a taxpayer's negligence or disregard of rules or regulations. I.R.C. §6662(a), §6662(b)(1), and §6663.

Definition of Negligence

Generally, negligence is the failure to do what a reasonable and ordinarily prudent person would do under the circumstances. Neely v. Commissioner, 85 T.C. 934, 947 (1985). More specifically, negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code; to exercise ordinary and reasonable care in the preparation of a tax return; and to keep adequate books and records as required by I.R.C. §6001. I.R.C. §6662(c); Treas. Reg. §1.6662-3(b)(1); H.R. Conf. Rep. No. 213, 103d Cong., 1st Sess., 668 (1993), reprinted in 1993 U.S.C.C.A.N. 378, 1357.

Definition of Disregard

Disregard includes any careless, reckless, or intentional

disregard of rules and regulations. I.R.C. §6662(c); Treas. Reg. §1.6662-3(b)(2); H.R. Conf. Rep. No. 213, 103d Cong., 1st Sess., 668, reprinted in 1993 U.S.C.C.A.N. 1088, 1357. "Rules or regulations" specifically include provisions of the Internal Revenue Code. Treas. Reg. §1.6662-3(b)(2).

A disregard of rules or regulations is careless if the taxpayer does not exercise reasonable diligence to determine the correctness of a return position that is contrary to the rule or regulation. Treas. Reg. §1.6662-3(b)(2). A disregard is reckless if the taxpayer makes little or no effort to determine whether a rule of regulation exists under circumstances which would demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe. Treas. Reg. §1.6662-3(b)(2). A disregard is intentional if the taxpayer knows of the rule or regulation that is disregarded. Treas. Reg. §1.6662-3(b)(2).

Burden of Proof

The taxpayer bears the burden of proving that understatements of tax are not attributable to negligence and/or disregard of rules and regulations. See Stovall v. Commissioner, 762 F.2d 891, 895 (11th Cir. 1985); Cates v. Commissioner, 716 F.2d 1387, 1390 (11th Cir. 1983); Marcello v. Commissioner, 380 F.2d 499, 507 (5th Cir. 1967), cert. denied, 389 U.S. 1044 (1968); Neely, 85 T.C. at 947; Bixby v. Commissioner, 58 T.C. 757, 791 - 792 (1972), acq. 1975-2 C.B. 1.

To satisfy its burden, the taxpayer must show that it acted reasonably and prudently by exercising due care in the preparation of its tax return. Tippin v. Commissioner, 104 T.C. 518, 534 (1995)(taxpayer failed to produce evidence of reasonableness of unsubstantiated deductions); Neely, 85 T.C. at 947 - 948 (taxpayers failed); Northwestern Indiana Telephone Co. v. Commissioner, T.C. Memo 1996-168, aff'd on other grounds, 127 F.3d 643 (7th Cir. 1997), cert. denied, 119 S. Ct. 41 - 42 (1998) (corporate taxpayer failed to show due care in claiming improper deductions); Paleveda v. Commissioner, 83 AFTR2d 99-2140 (11th Cir. 1999) (no evidence submitted as to use of due care).

In determining whether a corporation is liable for the penalty for negligence or disregard of rules and regulations, the acts of officers on behalf of a corporation performed in that capacity are imputed to the corporation. See DiLeo v. Commissioner, 96 T.C. 858, 875 (191), aff'd on other grounds, 959 F.2d 16 (2d Cir. 1992); Auerbach Shoe Co. v. Commissioner, 21 T.C. 191, 194 (1953), aff'd, 216 F.2d 693, 697 - 698 (1st Cir. 1954); Loftin & Woodward, Inc. v. United States, 577 F.2d 1206, 1244 (5th Cir. 1978); O.S.C. & Associates, Inc. v. Commissioner, T.C. Memo 1997-300, aff'd on other grounds, 84 AFTR2d

¶99-5192 (9th Cir. August 16, 1999) (taxpayer's accountant drafted incentive compensation plan that applied to only two officer-directors who comprised a two-thirds majority of taxpayer's Board and Board approved plan); Ibabao Med. Corp. v. Commissioner, T.C. Memo 1988-285 (assertion of negligence penalty sustained against corporation); M.S. Food Stores, Inc. v. Commissioner, T.C. Memo 1996-218 (corporate president failed to disclose fully to corporate accountant information necessary to keep proper records and file accurate returns).

Negligence in Claiming Improper Depreciation Deductions

When a taxpayer fails to produce adequate evidence of its efforts to comply with applicable internal revenue laws with respect to an improper depreciation deduction, the Service's assertion of a negligence penalty on the portion of the understatement attributable to such improper deduction has been consistently sustained. See Southern Boiler Sales & Service, Inc. v. Commissioner, T.C. Memo 1996-13 (penalty under I.R.C. §6662(b)(1) on amount conceded by taxpayer); Tennessee Securities, Inc. v. Commissioner, T.C. Memo 1978-434, aff'd, 674 F.2d 570 (6th Cir. 1982) (penalty under former I.R.C. §6653(a) on amount conceded by taxpayer); Extrusions, Inc. v. Commissioner, T.C. Memo 1994-610.

Specific factors that tend to establish that a taxpayer was negligent with respect to an improper depreciation deduction have included the following:

a. The case did not involve any complex legal question. Hobson Motor Co. v. Commissioner, T.C. Memo 1990-29.

b. The taxpayer claimed depreciation even though the taxpayer did not satisfy clear requirements for depreciation. Stan Frisbie, Inc. v. Commissioner, T.C. Memo 1990-419 (taxpayer did not comply with long-standing requirement that taxpayer substantiate business usage of property); French v. Commissioner, T.C. Memo 1990-314 (taxpayer admitted that erroneous deductions should not have been claimed without showing business connection and did not explain discrepancy between extent of unsubstantiated and substantiated business expenses and the reasons for claiming some expenses that clearly related to personal use and airplane travel related to activity where taxpayer lived); Ridgway v. Commissioner, T.C. Memo 1989-18 (taxpayer testified that he lacked profit motive); Joint Implant Surgeons, Inc. v. Commissioner, T.C. Memo 1988-558 (taxpayer claimed depreciation deductions on assets installed at personal residence in egregious violation of I.R.C. §262); Ottow v. Commissioner, T.C. Memo 1994-319 (portion of deductions were attributable to nondeductible personal expenses under I.R.C. §262); Arditto v. Commissioner,

T.C. Memo 1971-210, aff'd by unpublished order (9th Cir. February 11, 1974) (taxpayer knew or should have known that he deducted depreciation on personal boat owned by taxpayer's son).

c. The taxpayer possessed relevant tax experience and/or knowledge. Joint Implants Surgeons, Inc., T.C. Memo 1988-558 & n. 25 (in light of the intelligence and knowledge of responsible corporate officers/shareholders, blind reliance on advice that clearly nondepreciable assets were depreciable was "unfathomable"); Elliott v. Commissioner, 90 T.C. 960, 974 (1988), aff'd in unpublished opinion, 899 F.2d 18 (9th Cir. 1990) (taxpayer's knowledge of the rules and regulations of the Internal Revenue Code in claiming deductions indicated that taxpayer knew about other provisions of the Internal Revenue Code under I.R.C. §183 restricting entitlement to deductions); Ridgway, T.C. Memo 1989-18 (taxpayer's experience as a practicing attorney specializing in real estate implied taxpayer's familiarity with general depreciation rules); Arditto, T.C. Memo 1971-210 (experienced tax lawyer); Green v. Commissioner, T.C. Memo 1993-93 (taxpayer was a certified public accountant and the chief financial officer in charge of corporate financial and tax areas).

d. Taxpayer structured the transaction related to the improper depreciation deductions. Schwartz v. Commissioner, T.C. Memo 1994-320, aff'd without published opinion, 80 F.3d 558 (D.C. Cir. 1996).

e. The taxpayer knew of facts that were inconsistent with the information placed on the tax return. McCrary v. Commissioner, 92 T.C. 827, 849 - 850 (1989); Saltzman v. Commissioner, T.C. Memo 1994-641, rev'd and remanded on other grounds, 131 F.3d 87 (2d Cir. 1997) (taxpayer used a 4-year useful life when life under contract executed by taxpayer provided life of 8 years); Robertson v. Commissioner, T.C. Memo 1994-424, on reconsideration, T.C. Memo 1999-130.

f. Taxpayer failed to establish that correct information was provided to the return preparer and that the improper depreciation deduction claimed on return was result of preparer's error. Extrusions Division, Inc., T.C. Memo 1994-610 (taxpayer did not establish that taxpayer provided preparer with information as to ownership or investment in assets or that preparer was responsible for determining relevant matters).

Issue 1 - Application of Law to Facts

The file contains evidence that indicates that [redacted] was both

negligent and disregarded rules and regulations under I.R.C. §6662(b)(1). Such evidence should preclude [redacted] from establishing that it acted as a reasonable and ordinarily prudent person would in making a reasonable attempt to comply with the provisions of the Internal Revenue Code and to prepare an accurate tax return.

[redacted] claim of improper depreciation deductions constituted negligence and the failure to do what a reasonable and ordinarily prudent person would do for at least eight reasons. First, [redacted], as a party to the agreement with the [redacted], played a major role in structuring the transaction under I.R.C. §142(b). Second, there was no complex legal question. Hobson Motor Co., T.C. Memo 1990-29. Third, the depreciation deductions were egregious violations of clear prohibitions on deductions under I.R.C. §142(b)(1)(B)(i). Joint Implant Surgeons, Inc., T.C. Memo 1988-558; Stan Frisbie, Inc., T.C. Memo 1990-419. Fourth, [redacted] experience and/or knowledge in taxation and execution of the agreement indicated that [redacted] knew the applicable rules under I.R.C. §142. Elliott, 90 T.C. at 974; Joint Implants Surgeons, Inc., T.C. Memo 1988-558 & n. 25. [redacted] experience is indicated by its large staff of employees devoted exclusively to compliance with federal and other tax laws.

Fifth, [redacted] ignored its irrevocable election not to claim the depreciation contained in its agreement in its possession and required by the provisions of I.R.C. §142(b)(1)(B)(i) and a person that exercises due care would not have done so. See Saltzman, T.C. Memo 1994-641. Sixth, the claimed deductions reflected that [redacted] did not provide correct information to its employees who prepared its returns. See Extrusions Division, Inc., T.C. Memo 1994-610. Seventh, the claimed deductions show that [redacted] did not maintain adequate records to correctly determine its proper depreciation deductions and related tax liabilities or did not have sufficient internal controls to ensure that the employees responsible for preparing [redacted] Forms 1120 for the years ended December 31, [redacted] and December 31, [redacted] were provided with the agreement in which [redacted] agreed not to claim the deductions. Eighth, the file is devoid of any evidence of [redacted] good faith and reasonable cause for claiming the improper deductions.

[redacted] claim of improper depreciation deductions also constituted careless, reckless, or intentional disregard of rules and regulations. First, [redacted] execution of the agreement with the irrevocable election under I.R.C. §142(b)(1)(B)(i) and claim of the improper deductions indicates at least careless disregard because [redacted] appears not to have examined the relevant information in its possession or seek pertinent advice and, hence, did not exercise reasonable diligence to determine the correctness of the improper deductions. Treas. Reg. §1.6662-3(b)(2). Second, such actions show that [redacted] made no effort to determine the correctness of the deductions and relevant statutory

authority under I.R.C. §142(b) and demonstrates a substantial deviation from the standard of conduct that a reasonable person would observe. Treas. Reg. §1.6662-3(b)(2). Third, [redacted] execution of the agreement indicates that it knew of the provisions of I.R.C. §142(b)(1)(B)(i) prohibiting the claimed deductions and, hence, intentionally disregarded such provisions. See Treas. Reg. §1.6662-3(b)(2).

Issues 2 and 3 - Exceptions to Imposition of Penalty

There are two exceptions to assertion of the penalty under I.R.C. §6662(a) based on negligence or disregard of rules and regulations under I.R.C. §6662(b)(1): (a) adequate disclosure of a taxpayer's return position contrary to rules and regulations; and (b) the taxpayer's reasonable cause and good faith. See Treas. Reg. §1.6662-3(a).

Issue 2 - Adequate Disclosure Exception

For returns due after December 31, [redacted] (determined without regard to extensions for the time of filing), the penalties attributable to disregarding rules or regulations in I.R.C. §6662(b)(1) may be avoided by an adequate disclosure of a return position that has a reasonable basis. See Treas. Regs. §1.6662-1 and §1.6662-3(c)(1); Temp. Treas. Regs. §1.6662-7T(a)(2) and §1.6662-7T(c)(1994); T.D. 8533, 1994-1 C.B. 307, 308.

Adequate disclosure of a return position for an item or group of items for a taxable year that is contrary to an applicable statute occurs when the taxpayer files a properly completed Form 8275 attached to the return for the taxable year that adequately identifies the following:

(a) The item or group of similar items, including the location of the items on the return (such as Schedule and line) and amount of the disclosed item;

(b) A description of the relevant facts affecting the tax treatment of the item and the nature of the potential controversy concerning the item's tax treatment or a concise description of the legal issue presented by the facts; and

(c) The statutory provision that is contrary to the return position.

See Treas. Regs. §1.6662-3(c)(2), §1.6662-4(f)(1), and §1.6662-4(f)(2); Form 8275 and related instructions.

In addition, disclosure with respect to a recurring item, such as the basis of recovery property, must be made for each taxable year in which the item is taken into account. See Treas. Regs. §1.6662-4(f)(3).

However, this disclosure exception specifically is not applicable when a taxpayer's position lacks a reasonable basis. See Temp. Treas. Reg. §1.6662-7T(c) (1994). In addition, adequate disclosure will not avoid the penalty when the taxpayer failed to keep adequate books and records with respect to the item or position. Treas. Regs. §1.6662-3(c)(1) and §1.6662-4(e)(2)(iii). Furthermore, this disclosure exception does not apply to the penalty for negligence under I.R.C. §6662(b)(1). Treas. Reg. §1.6662-3(c)(2); See Temp. Treas. Reg. §1.6662-7T(b) (1994); H. R. Conf. Rep. No. 213, 103d Cong., 1st Sess. 699 (1993), reprinted in 1993 U.S.C.C.A.N. 1088, 1358.

When a taxpayer makes an adequate disclosure with respect to an item, the item is treated as if it were shown properly on the return and the tax attributable to such item is not subject to any penalty under I.R.C. §6662. See Treas. Reg. §1.6662-4(e)(1).

Requirements of Revenue Procedure 94-69

Pursuant to the authority to promulgate revenue procedures that prescribe the manner in which the rules governing qualified amended returns that apply to particular classes of taxpayers under Treasury Regulation §1.6664-2(c)(4), the Service issued Revenue Procedure 94-69 for CEP taxpayers.

In lieu of submitting a qualified amended return with an attached Form 8275 under Treasury Regulation §1.6664-2(c)(3), Revenue Procedure 94-69 provides CEP taxpayers with a special procedure for disclosure that avoids imposition of the accuracy-related penalty under I.R.C. §6662 after notification of the commencement of an examination. See 1994-2 C.B. 804 - 805.

To make an adequate disclosure that avoids such penalty with respect to any deduction that is contrary to statutory provisions and claimed on a tax return placed under examination by the Service, a CEP taxpayer must furnish to the Service a written statement that contains the following items:

(a) A description of the item that would result in an adjustment to the tax return and that consists of information that reasonably may be expected to apprise the Service of the identity and amount of an item and the nature of the controversy or potential controversy; and

(b) An adequate identification of the statutory provision in question.

See Rev. Proc. 94-69, 1994-2 C.B. at 805 - 806.

The provisions of Revenue Procedure 94-69 do not dispense with the CEP taxpayer's obligation to satisfy the applicable provisions of the Treasury Regulations to avoid the penalty under I.R.C. §6662 for any taxable year. See 1994-2 C.B. at 806. Consequently, as for other taxpayers, a CEP taxpayer may not disclose to avoid the negligence penalty, but may disclose to avoid the disregard of rules and regulations penalty only if the taxpayer's position had a reasonable basis. Rev. Proc. 94-69, 1994-2 C.B. at 806; Temp Treas. Reg. §1.6662-7(b)(1994); HR. Conf. Rep. No. 213, 103d Cong., 1st Sess. 669 (1993), reprinted in 1993 U.S.C.C.A.N. 1088, 1358.

Judicial Standards for Adequate Disclosure

We have not located any cases that involve the adequacy of disclosure by CEP taxpayers under Revenue Procedure 94-69. However, numerous cases determine the definition of adequate disclosure by taxpayers based on the contents of their returns and attached statements under I.R.C. §6662, former I.R.C. §6661 (repealed with enactment of I.R.C. §6662 for taxable years related to returns due after December 31, 1989), and related Treasury Regulations.

A taxpayer makes an adequate disclosure if the taxpayer includes sufficient relevant information in its disclosure to enable the Internal Revenue Service (Service) to identify the potential controversy or issue involved. Reinke v. Commissioner, 46 F.3d 760, 765 (8th Cir. 1995); Little v. Commissioner, 106 F.3d 1445, 1453 (9th Cir. 1997); Schirmer v. Commissioner, 89 T.C. 277, 285 - 286 (1987), acq. 1989-1 C.B. 1; Rebecca K. Crown Income Charitable Fund. v. Commissioner, 98 T.C. 327, 340 (1992), aff'd on other grounds, 8 F.3d 571 (7th Cir. 1993) (returns related to charitable lead trust that reflected that claimed charitable deductions exceeded the annual charitable annuity amount of $975,000.00 put the Service on notice that deductions might exceed amounts paid to charities under I.R.C. §642(c)); Hotel Continental, Inc. v. Commissioner, T.C. Memo 1995-354, aff'd in unpublished opinion, 113 F.3d 1241 (9th Cir. 1995).

The disclosure must be arranged in a manner that reasonably may be expected to apprise the Service of the identity of the item, its amount, and the nature of the controversy. See Cramer v. Commissioner, 101 T.C. 225, 255 (1993), aff'd, 64 F.3d 1406 (9th Cir. 1995), cert. denied, 116 S. Ct. 2499 (1996); McCoy Enterprises, Inc. v. Commissioner, 58 F.3d 557 (10th Cir. 1995); Mitchell v. Commissioner, T.C. Memo 1994-237, aff'd on other grounds, 73 F.3d 628

(6th Cir. 1996) (deduction of $755,172.00 that was sole item on a Schedule C under business listed as "Chairman Savings & Loan" and attached statement that payment of $75,172.00 to bank required by Federal Home Loan Bank Board for related party loss was treated as trade or business loss deemed adequate to disclose capital expenditure/ordinary loss controversy); Wright v. Commissioner, T.C. Memo 1993-238, aff'd without published opinion, 73 F.3d 372 (9th Cir. 1995).

The determination of an adequate disclosure depends on the facts and circumstances of the particular case. Parchutz v. Commissioner, T.C. Memo 1988-327. However, an adequate disclosure does not rest merely on whether the taxpayer identified the correct section of the Internal Revenue Code to support a claimed deduction. Elliott v. Commissioner, T.C. Memo 1997-294, aff'd 149 F.3d 1187 (8th Cir 1998) (returns indicated that claimed deductions under I.R.C. §1244 and taxpayer subsequently argued that deductions allowable under I.R.C. §166).

Factors that put the Service on notice of potential controversies related to returns for purposes of an adequate disclosure related to an item have included the following:

a. The taxpayer did not conceal the position taken on the return. Fellouzis v. United States, 896 F. Supp. 1166, 1169 (M.D. Fla. 1995) (appraisals listing each art object and amount attached to return were adequate for claimed charitable contribution); Stein v. Commissioner, T.C. Memo 1992-652 (notation on return related to deduction of severance payment of $44,625.00 from income, attached Form 4972 reflecting tax computation under 10-year averaging, and attached explanation of payment from third party indicated potential controversy).

b. The amounts relied on by the Service in the adjustments to income were taken directly from the taxpayer's disclosure. Barnette v. Commissioner, T.C. Memo 1992-371, aff'd without published opinion, 41 F.3d 667 (11th Cir. 1994); Goudas v. Commissioner, T.C. Memo 1996-555, aff'd 137 F.3d 368 (6th Cir. 1998).

c. The disclosure contained information that flagged problems that generated or appeared to generate the audits. Andrew-Crispo Gallery, Inc. v. Commissioner, T.C. Memo 1992-106, aff'd in part and rev'd in part on other grounds, 16 F.3d 1336 (2d Cir. 1994) (attachments reflected that not all records subpoenaed by government had been returned; that returns may not contain items in such unavailable records; and that sales and related costs determined by Service's personnel, taxpayer's representatives,

available purchase invoices and confirmations, and recollections of taxpayer's chief operating officer); Schmidt v. Commissioner, T.C. Memo 1989-188, aff'd without published opinion, 891 F.2d 283 (3d Cir. 1989), cert. denied, 494 U.S. 1067 (1990) (return reported amount as nontaxable wages); Crouch v. Commissioner, T.C. Memo 1990-309 (return showed self employment income and expenses, but Schedule SE showed no self employment tax liability and attachment renounced social security benefits and obligation to pay self employment tax); Goudas, T.C. Memo 1996-555 (Form 8082 (Notice of Inconsistent Treatment or Amended Return) disclosed reduction to $0.00 in amount of reported 1231 gain attributed to taxpayer by K-1 issued to taxpayer due to trading in like-kind exchange); Henry v. Commissioner, T.C. Memo 1997-29, rev'd and remanded on other grounds, 170 F.3d 1217 (D.C. Cir. 1999) (controversy of whether stock option proceeds properly treated as long term capital gain identified by return's listing of dates acquired and sold, sales, price, a basis of zero, and gain involved); Kamholz v. Commissioner, T.C. Memo 1990-192 (Schedules C for activity listing expenses and deductions reflected "Boat in drydock for refurbishing" adequately disclosed controversy under I.R.C. §183); Novack v. Commissioner, T.C. Memo 1989-598, aff'd without published order, 930 F.2d 28 (9th Cir. 1991) (attachment disclosing nature and amount of deduction and manner in which calculated was adequate); Wells v. Commissioner, T.C. Memo 1995-537.

Factors that have supported a finding of an inadequate disclosure related to an item of deduction or loss include the following:

a. Taxpayer merely listed nature and amount of deduction without additional explanation of the underlying facts and true nature of claimed deductions. Accardo v. Commissioner, 942 F.2d 444, 453 (7th Cir.1991), cert. denied, 503 U.S. 907 (1992) (deduction of $207,000.00 for legal fees for conservation of property held for production of income); Schirmer, 89 T.C. at 286 (listing of farm income and expenses on Schedule F and Form 4562); Crim v. Commissioner, T.C. Memo 1989-249, aff'd without published opinion, 899 F.2d 1221 (6th Cir. 1990) (listing of expenses and depreciation on Schedule F and Form 4562 did not disclose whether farming activity engaged in for profit); Bhatia v. Commissioner, T.C. Memo 1996-429 (losses from S corporation claimed without indication of the nature of debt on which claim of basis is made under I.R.C. §1366); Baggao v. Commissioner, T.C. Memo 1992-226 (listing of $22,000.00 as a bad debt from sales on a Schedule C with the heading "Sun and Surf Motel" was inadequate disclosure for payment to protect investment in corporation that was a nonbusiness bad debt under I.R.C. §166); Brooks v. Commissioner, T.C. Memo 1990-259 (notation "BUS BAD DEBT" without disclosing

debtor's name or other relevant facts insufficient to disclose specific bad debt charge-off); Crouch. T.C. Memo 1990-309 (returns merely listed carryover of purported excess charitable contribution of future social security benefits of cash method taxpayer, but returns and attachments failed to reflect nature, value, and method of determining value of purported contribution); Schaeffer v. Commissioner, T.C. Memo 1994-227 (deductions claimed on three Schedules disallowed for lack of substantiation or underlying personal purpose).

b. Information disclosed is incomplete. McCoy Enterprises, Inc., 64 F.3d at 1415; Lair v. Commissioner, 95 T.C. 484, 494 (1990) (disclosure that item for which taxpayer claimed short term capital loss involved guarantee, but not that recipient was taxpayer's son or that taxpayer entered guaranty agreement without receiving consideration from son); Fortner v. Commissioner, T.C. Memo 1993-195 (attachment to Schedule C untruthfully reflected "hedging losses", which did not indicate that losses were from cotton futures trading, was inadequate to disclose the controversy that such trading was surrogate for inventory under Arkansas Best); Kelly v. Commissioner, T.C. Memo 1996-529 (inaccurate identification of Schedule C business as "options dealer" was insufficient to apprise of controversy related to character of trading losses as capital or ordinary); Wright, T.C. Memo 1993-238 (return did not clearly disclose consultant fees related to issue of whether payments constituted reasonable compensation or constructive dividends).

Reasonable Basis for Position

The reasonable basis standard for the disclosure exception is a relatively high standard of tax reporting that is significantly higher than the standard of not frivolous. Temp. Treas. Reg. §1.6662-7T(d)(2)(1994). The standard of not frivolous is that an item is patently improper. See Treas. Reg. §1.6662-3(b)(3)(regulation in effect before effective date of Treasury Regulations promulgated after OBRA).

Issue 2 - Application of Law to Facts

[redacted] failed to make an adequate disclosure that would preclude assertion of penalties attributable to disregard of rules and regulations under I.R.C. §6662(b)(1) for at least two reasons. First, [redacted] did not make any disclosure that would have apprised the Service of the nature of any potential controversy involving the restrictions on depreciation deductions under I.R.C. §142(b)(1)(B)(i) for the taxable years ended December 31, [redacted] and December 31, [redacted]. See Rev. Proc. 94-69, 1994-2 C.B. at 805 - 806; Cramer, 101 T.C. at 255; McCoy

Enterprises, Inc., 58 F.3d 557); Reinke, 46 F.3d at 765; Little, 106 F.3d at 1453; Schirmer, 89 T.C. at 285 - 286. Although [redacted] made a disclosure under Revenue Procedure 94-69, such disclosure did not identify the amounts of the improper depreciation deductions or the nature of any potential controversy involving the restrictions on deductions under I.R.C. §142(b)(1)(B) for either of the taxable years ended December 31, [redacted] and December 31, [redacted]. Such disclosure merely disclosed that [redacted] financed the construction of a facility at [redacted] with proceeds from tax exempt bonds and that [redacted] claimed overstated depreciation deductions under the improper method of regular MACRS. The disclosure failed to reflect that [redacted] was not entitled to any portion of such deductions under [redacted] irrevocable election under I.R.C. §142(b)(1)(B)(i).

While [redacted] may argue that its disclosure of an improper method for computing depreciation related to the deductions reflected information that flagged problems that generated the audit under the authority of cases such as Novack, T.C. Memo 1989-598, and Andrew-Crispo Gallery, Inc., T.C. Memo 1992-106, [redacted] disclosure was incomplete because it did not reveal the ground for disallowance and issue related to its election under I.R.C. §142(b)(1)(B)(i).

Second, because the claimed depreciation deductions violated the provisions of [redacted] agreement and irrevocable election under I.R.C. §142(b)(1)(B)(i), [redacted] claimed deductions lacked a reasonable basis. See Temp. Treas. Reg. §1.6662-7T(c) (1994). [redacted] claimed deductions were at a minimum patently improper. Third, [redacted] claimed deductions and failure to disclose the existence of the agreement and election not to claim the deductions in [redacted] disclosure under Revenue Procedure 94-69 indicates that [redacted] did not maintain adequate records with respect to properly depreciable assets necessary to properly determine its tax liabilities at the time of filing of the returns or when [redacted] filed its disclosure. Treas. Regs. §1.6662-3(c)(1) and §1.6662-4(e)(2)(iii). Fourth, [redacted] inadequate disclosure on [redacted] reflects that [redacted] still had made no real effort to determine the requirements precluding the claimed depreciation deductions more than two years after the filing of [redacted] Form 1120 for the year ended December 31, [redacted].

Issue 3 - Reasonable Cause and Good Faith Exception

Penalties under I.R.C. §6662(b)(1) for either negligence or disregard of rules and regulations may not be imposed on any portion of an underpayment if the taxpayer shows that there was reasonable cause for and the taxpayer acted in good faith with respect to such portion. I.R.C. §6664(c); Treas. Regs. §1.6662-1, §1.6662-3(a), §1.6664-1(a), and §1.6664-4(a).

The determination of whether a taxpayer acted with reasonable cause and in good faith is made based on all pertinent facts and circumstances of each case. Treas. Regs. §1.6664-4(b)(1) and §1.6664-4(b)(2) Exs. 1 & 2; Asat, Inc. v. Commissioner, 108 T.C. 147, 175 (1997). The most important factor is the extent of the taxpayer's efforts to assess the taxpayer's proper tax liability. Treas. Reg. §1.6664-4(b)(1); Asat, Inc., 108 T.C. at 75 - 176. Circumstances that may indicate reasonable cause and good faith include the following general factors:

a. The taxpayer did not know or have reason to know that the information was incorrect. Treas. Reg. §1.6664-4(b)(1) (incorrect information on information return); Henry, 170 F.3d at 1220 - 1223 (taxpayer lacked knowledge of the rule or regulation contrary to improper return position).

b. The taxpayer had a reasonable basis for its tax treatment of an item. Treas. Reg. §1.6662-3(b)(1) (a return position that has a reasonable basis is not attributable to negligence).

c. The taxpayer's lack of relevant tax experience, knowledge, and education. Columbia Steak House II, Inc. v. Commissioner, T.C. Memo 1981-142 (directors and officers of a corporate taxpayer lacked sophistication in taxation).

d. The amount of item related to understatement of tax was immaterial. Treas. Reg. §1.6664-4(b)(2) Ex. 3 (taxpayer, who relied on Form W-2 that omitted 4.7% of wages and failed to report those wages, had no reason to know that Form W-2 was incorrect and acted in good faith).

e. The issue related to the disputed deduction was one of first impression and subject to reasonable debate. Everson v. United States, 108 F.3d 234, 238 (9th Cir. 1997) (application of I.R.C. §175 precluded improper depreciation deductions under I.R.C. §167 and §168 claimed on trees planted to prevent soil erosion)

f. The error was an isolated computational or transcriptional error. Treas. Reg. §1.6664-4(b)(1).

g. The taxpayer seeks advice from and/or reasonably relies in good faith on a professional advisor. Treas. Regs. §1.6664-4(b)(1) and §1.6664-4(b)(2) Exs. 1 & 2.

For a large, multidivisional corporation, reliance on erroneous information (such as an error relating to the cost or adjusted basis of property, the date property was placed in service, or the amount of opening or closing inventory) inadvertently included in data compiled

by or in financial books and records prepared by the divisions of the corporation generally indicates reasonable cause and good faith if the corporation employed internal controls and procedures that were reasonable under the circumstances and that were designed to identify such factual errors. Treas. Reg. §1.6664-4(b)(1).

However, the lack of reasonable cause and good faith is indicated by the following general factors:

a. The taxpayer structured the transaction. Schwartz, T.C. Memo 1994-320 (the taxpayer was not a "naif overawed by a persuasive promoter with impressive credentials").

b. The taxpayer's failure to provide the return preparer with complete or accurate information and the error was the result of the preparer's error. Ma-Tran Corp. v. Commissioner, 70 T.C. 158, 173 (1978); Enoch v. Commissioner, 57 T.C. 781, 802 - 803 (1972), acq. 1974-1 C.B. 1, nonacq. on other issues, 1974-1 C.B. 2 (taxpayer did not take time to consult with or inform persons of transactions appearing on returns); Asat, Inc., 108 T.C. at 176; Auld v. Commissioner, T.C. Memo 1878-508 (taxpayer misinformed preparer of fact best known to taxpayer or ignored incorrect information).

c. The taxpayer knows or has reason to know that information placed on return was not correct or inconsistent with other information reported or otherwise furnished to the taxpayer or the taxpayer's knowledge of the transaction. Treas. Reg. §1.6664-4(b)(1); McCrary, 92 T.C. at 849 - 850 (taxpayers knew that assumed facts in tax opinion for tax shelter were inaccurate); Robertson, T.C. Memo 1994-424, on reconsideration, T.C. Memo 1999-130.

d. The taxpayer exhibits indifference to the proper tax treatment of an item. Bradley v. Commissioner, 57 T.C. 1, 11 (1971) (despite question arising during preparation and need for some legal research, taxpayer did not submit evidence as to what, if any, legal advice taxpayer received).

e. The case did not involve any sophisticated or difficult issue or ambiguity or uncertainty in the law as to tax consequences of item. Edison Homes, Inc. v. Commissioner, 903 F.2d 579, 584 (8th Cir. 1990), cert. denied, 498 U.S. 984 (1990)(when taxpayer failed to comply with a simple or unambiguous statutory requirement, the court rejected argument that taxpayer was not negligent because it interpreted relatively obscure provision of law different from Service); Pessin v. Commissioner, 59 T.C. 473, 489 (1972); Ma-Tran Corp., 70 T.C. at 173.

f. A taxpayer's experience in taxation. See Tippin v. Commissioner, 104 T.C. 518, 534 (1995) (attorney specializing in taxation and bankruptcy).

g. The taxpayer's failure to make a meaningful or substantial investigation or seek counsel of knowledgeable or experienced advisors in the matter indicates a lack of the requisite due care. Luehsler v. Commissioner, 963 F.2d 907, 910 (6th Cir. 1992) (taxpayer, a certified public accountant, was educated and experienced in investment and tax matters).

In addition, a corporate taxpayer cannot show due care by mere general testimony concerning its department responsible for tax matters or the complexity of the taxpayer's business and the resulting complex matters related to improper items on a tax return. Kenroy, Inc. v. Commissioner, T.C. Memo 1984-232 (burdens of preparing for public offering and illness of chief accountant during relevant time did not excuse errors on return). Furthermore, the fact that the Service's adjustments may be considered technical or complex does not preclude imposition of the negligence penalty against a corporation that normally engages in sophisticated business transactions. Kenroy, Inc., T.C. Memo 1984-233 (adjustments were not beyond comprehension of accounting department when adjustments mirrored complexity of taxpayer's business operations).

Issue 3 - Application of Law to Facts

The file lacks evidence that establishes reasonable cause and good faith under I.R.C. §6664(c) to preclude assertion of the penalties attributable (a) negligence and/or (b) disregard of rules and regulations under I.R.C. §6662(b)(1). The circumstances of this case reflect that [redacted] made no genuine efforts to assess its proper tax liability as required by Treasury Regulation §1.6664-4(b)(1).

The following factors refute [redacted] lack of good faith in the preparation of its returns for the taxable years ended December 31, [redacted] and December 31, [redacted]:

a. [redacted] played an important role in structuring the transaction. See Schwartz, T.C. Memo 1994-320.

b. [redacted] claimed the deductions despite its agreement and irrevocable election under I.R.C. §142(b)(1)(B)(i). Such agreement reflects that [redacted] knew or had reason to know that the deductions were improper and lacked any reasonable basis for its tax treatment of an item. Treas. Reg. §1.6664-4(b)(1); McCrary, 92 T.C. at 849 - 850.

c. The clear requirements of I.R.C. §142(b)(1)(B)(i) do not involve any sophisticated or difficult issue or ambiguity or uncertainty in the law as to tax consequences. Edison Homes, Inc., 903 F.2d at 584; Pessin, 59 T.C. at 489; Ma-Tran Corp., 70 T.C. at 173.

d. As indicated by its staff of employees devoted exclusively to compliance with tax laws, [redacted] has experience in taxation. See Tippin, 104 T.C. at 534.

e. Although [redacted] is known to make extensive use of outside accounting services, [redacted] failed to make any meaningful or substantial investigation or seek counsel of knowledgeable or experienced advisors in the matter. Such failures exhibit [redacted] indifference to the proper tax treatment of its leased assets at [redacted] financed by tax-exempt bonds. Luehsler, 963 F.2d at 910; Bradley, 57 T.C. at 11. In addition, even if [redacted] had sought appropriate advice, it is unfathomable to believe that any competent tax advisor, who was informed of all facts, would have advised [redacted] that the claimed depreciation deductions were proper.

[redacted] may argue that the amount of the improper deductions were so immaterial that it should not have known of the errors on its returns for the years ended December 31, [redacted] and December 31, [redacted]. See Treas. Reg. §1.6664-4(b)(2) Ex. 3. However, such argument should fail for at least four reasons. First, the penalty under I.R.C. 6662(b)(1) does not require that an understatement exceed a minimum amount as required by the provisions applicable to the penalties for substantial understatements under I.R.C. §6662(b)(2). See I.R.C. §6662(d)(1)(A) and §6662(d)(1)(B). Second, because all circumstances of a case determine a taxpayer's exercise of due care, materiality of an understatement is not the sole determining factor. Paleveda, 83 AFTR2d 99-2140 (claim that the majority of a return was correct did not preclude application of negligence penalty). Third, materiality appears to be critical (a) when the taxpayer lacks reason to know of an error or (b) the reasonableness of the claimed amount, not entitlement to a deduction, was in issue and the taxpayer establishes that the overstated deduction was substantially reasonable. See Treas. Reg. §1.6664-4(b)(2) Ex. 3; Summit Publishing Co. v. Commissioner, T.C. Memo 1990-288 (taxpayer was not negligent when only $2,780.00 out of claimed compensation of $72,780.00 disallowed for one year, but negligent when $98,910.00 of claimed compensation of $183,910.00 was disallowed for second year); Heitz v. Commissioner, T.C. Memo 1998-220, appeal by taxpayer (7th Cir. December 23, 1998) (deduction was substantially reasonable when 70% of claimed deduction was allowed). Fourth, the extent of any immateriality of amount in terms of an amount or a percentage of [redacted] income or deductions for any year is far outweighed by [redacted] agreement that it would not claim

depreciation in order to receive tax-exempt financing.

[redacted] also may argue that it had reasonable cause and good faith because it is a large, multidivisional corporation engaged in many complex business and tax matters that inadvertently failed to include in [redacted] books and records the relevant contract and election information in accordance with Treasury Regulation §1.6664-4(b)(1). However, such an argument should fail for at least three reasons.

First, [redacted] has not established that it employed reasonable internal controls and procedures that were designed to identify the proper information and any related factual omission as required by Treasury Regulation §1.6664-4(b)(1). Second, [redacted] will have difficulty establishing due care in light of the generally complex nature of its business, the existence of many employees engaged in compliance with tax laws, and the clear requirements of I.R.C. §142(b)(1)(B)(i). See Kenroy, Inc., T.C. Memo 1984-232. [redacted] was not a "naif overawed by a persuasive promoter with impressive credentials". See Schwartz, T.C. Memo 1994-320.

Conclusion and Recommended Action

We have concluded that the current evidence supports assertion of the penalties for negligence and disregard of rules under I.R.C. §6662(a) and §6662(b)(1) based on the understatements of tax attributable to the disallowed depreciation deductions claimed on [redacted] Forms 1120 for the years ended December 31, [redacted] and December 31, [redacted]. In light of the above facts, [redacted] claim of the improper deductions is unfathomable.

However, because [redacted] has not yet been given the opportunity to present evidence of reasonable cause and good faith that might preclude assertion of such penalties under I.R.C. §6664, we recommend that the Examination Division give [redacted] such opportunity and request all documents and other information relevant to the claimed depreciation deductions. Such documents and information include, but are not limited to, the following:

a. Reasons as to why [redacted] claimed the improper deductions and failed to disclose the election in [redacted] disclosure under Revenue Procedure 94-69.

b. The identity of any department(s) and individual(s) at [redacted] involved in the financing and/or leasing of the facility. Such departments will include, but not be limited to, [redacted] Tax and/or Accounting Departments.

c. The identity of any department(s) and individual(s) at [redacted] that maintained or possessed the original or copy of the agreement and/or any related lease at the time that [redacted] prepared its Forms 1120 or disclosure under Revenue Procedure 94-69.

d. Details of [redacted] determination of the improper depreciation deductions related to the leased property. Such details include, but are not limited to, any workpaper, audit workpaper, general ledger, and/or written opinion or correspondence related to the deductibility of depreciation on the facility financed by the bonds by any person, in the possession of any employee, officer, director, agent, and/or any other representative of [redacted] and/or any external accountants and/or attorneys.

e. Any leases related to the [redacted] at [redacted] between the [redacted] and [redacted] and modification thereto.

If [redacted] is unable to produce credible evidence that it exercised due care, penalties under I.R.C. §6662(a) and §6662(b)(1) should be asserted against [redacted] with respect to the understatements of tax attributable to the improper depreciation deductions in any Form 5701, Form 886-A, RAR, or notice of deficiency issued to [redacted] for the taxable years ended December 31, [redacted] and December 31, [redacted]. In light of the agreement executed pursuant to I.R.C. §142(b)(1)(B)(i), it appears unlikely that [redacted] will be able to overcome its burden of establishing that it exercised due care under I.R.C. §6662 and §6664.

On the other hand, if [redacted] produces any evidence that tends to demonstrate reasonable cause and good faith, we recommend that you carefully consider whether the evidence is sufficient to satisfy [redacted] burden of refuting that the understatements are not attributable to negligence and disregard of rules and regulations. If you need assistance in making such determination, we will provide additional assistance upon request.

Because no further action is required by this office at this time, we are closing our file.

If you have any questions, please contact me at [redacted].

/s/ [redacted]

[redacted]
Special Litigation Assistant

cc: TL Cats

cc: [redacted]
Assistant Regional Counsel (LC)
[redacted]